

Column (C) of the example demonstrates that when the nonregulated LOB incurs a loss, the regulated operations absorb a tax expense which is greater than the amount for which the Company is liable to the Federal government. This is a permanent difference for which the Company will never be liable. The Company is able to use current expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tariffed, since the money retained from the higher tax expense charged to regulated operations serves to offset or subsidize the losses of the nonregulated LOB.

Effect

The Company's nonregulated lines of business lost money each year of the audit period. These losses were caused primarily by the losses of its Customer Premises Equipment (CPE) LOB. The amounts shown below were added back to regulated tax expense as a result of the nonregulated losses.

<u>Year</u>	<u>Tax Effects of Nonregulated Losses Added To Regulated Fit Expense</u>
1988	\$ 632,363
1989	5,712,729
1990	6,769,635
1991	<u>6,362,148</u>
Total	<u>\$19,476,875</u>

The amounts charged to regulated income tax expense were increased by the \$19.5 million shown above as a result of nonregulated losses even though the \$19.5 million was not and will not be paid to the Federal government. Consequently, the \$19.5 million charged to regulated tax expense reduced the regulated returns each year and also reduced (subsidized) the net after-tax losses of the nonregulated lines of business.

Cause

The Company believes that its adjustments result in an "equitable apportionment" between regulated and nonregulated income tax expense. It is the Company's position that when a nonregulated LOB loses money, any tax treatment other than that which it uses will result in a subsidy from nonregulated operations to regulated operations. This logic, with which the auditors disagree, is the root cause of the condition and effect discussed above.

Recommendation

Income taxes charged to regulated operations should not be used to subsidize the losses of nonregulated products and services offered by Southern Bell - Georgia. In order to stop the subsidy on a going-forward basis, the adjustments to total company and regulated tax expense should be limited to subtracting taxes resulting solely from the taxable income - not losses - of nonregulated lines of business. Regarding the past subsidies, the auditors recommend that the \$19.5 million which the Company debited

to the tax expense of its regulated operations over the four-year audit period be set up as an accumulated deferred tax amount with a corresponding debit to account 7220 - Operating FIT - Current Nonregulated. The accumulated deferred taxes should be deducted from rate base and amortized over a four-year period as equal annual reductions to regulated tax expense.

The Company believes that this adjustment would constitute an unlawful taking of Southern Bell's property in contravention of the 14th Amendment to the United States Constitution as well as analogous provisions of the Georgia Constitution. The Company also believes the recommended adjustment would contravene federal decisions on Hope and Bluefield, as well as case authority in Georgia.

There may or may not be merit to the Company's legal allegations. The auditors disagree, from a technical standpoint, that the recommended adjustment would constitute a "taking" of Southern Bell's property since the auditors believe the tax expense amounts in question were improperly charged to regulated operations. The auditors further believe that to continue this practice will continue an improper cross-subsidy.

4. The Commission should instruct the Company to match benefits to related costs.

Summary

It is axiomatic that costs and benefits should be matched. This finding identifies interest income (a benefit) received in 1991 by the Company relating to an amount included above-the-line in regulated rate base (a cost) for eight years. The Company's literal interpretation of the Part 32 USOA resulted in the entire benefit being recorded below-the-line, i.e. the benefit was not matched to the cost. The auditors recommend that the Commission instruct the Company to match specific benefits to related costs.

Criteria

Benefits should be matched to related costs.

Condition

In January, 1991 Southern Bell - Georgia received \$2.7 million in interest income from the IRS relating to a 1983 payment to the IRS. The 1983 payment was comprised of tax and interest associated with a 1978 disputed issue. The tax component of the 1983 payment resulted in a \$.8 million accumulated deferred tax debit which increased regulated rate base without any corresponding reduction to regulated tax expense. The interest portion of the 1983 payment was charged to nonregulated operations "below-the-line".

The interest income received in 1991 and recorded below-the-line related to both the interest expense and taxes paid in 1983.

Therefore, a portion of the interest income related directly to the \$.8 million amount which was included in Southern Bell - Georgia's rate base, above-the-line, for approximately 8 years.

Effect

Southern Bell - Georgia's nonregulated below-the-line operations derived a benefit at the expense of its regulated above-the-line operations. Although the regulated operations bore the carrying costs of a \$.8 million rate base amount for 8 years, none of the resulting benefits were matched to these costs.

Cause

Part 32 definitions place "interest income" below-the-line. In these circumstances, strict adherence to Part 32 enabled the company to derive a nonregulated benefit at the expense of regulated operations.

Recommendation

The Commission should instruct the Company to match benefits to related costs.

5. Accumulated deferred taxes and unamortized investment tax credits which represent taxes charged to regulated operations should not be transferred to nonregulated operations. Case-by-case burden of proof concerning any IRC violation belongs with the Company.

SUMMARY

Accumulated deferred income taxes ("ADITs") and unamortized investment tax credits ("ITCs") generated under regulation represent charges to tax expense for taxes that were not actually paid. In general, it is assumed that these tax amounts will eventually be used to reduce future tax expenses. If ADITs and unamortized ITCs are generated under regulation and then transferred to a nonregulated affiliate, the transfer results in a subsidy to the Company's shareholders. This finding identifies certain ADITs and unamortized ITCs transferred from Southern Bell - Georgia to nonregulated operations. These transfers may have resulted in such subsidies. Consequently, the auditors recommend that ADITs and unamortized ITCs generated under regulated operations not be transferred to nonregulated operations. Should the Company claim that such transfers are required to avoid IRS violations, the auditors recommend that the burden of proof be placed on the Company on a case-by-case basis.

Criteria

One of the objectives of this audit was to learn whether, as a result of the relationship between the Company's regulated telephone operations and its nonregulated activities and the

nonregulated operations of its affiliates, Southern Bell's regulated customers are protected from cross-subsidy.

Condition

During the course of the 1988 to 1991 audit period the Company made several asset transfers to and from affiliated companies. The accumulated deferred income taxes and unamortized investment tax credits associated with these assets were "transferred" along with the related assets. Certain of the ADITs and unamortized ITCs that were transferred represent tax expenses charged to regulated operations which were not actually paid. The quid-pro-quo is that these amounts would be used to reduce future regulated taxes. Once the ADITs and unamortized ITCs were transferred out of regulation, the Company was relieved of the necessity to reduce future regulated tax expense under the terms of the quid-pro-quo. *

The table below summarizes the specific transfers of which the auditors are aware:

Transfers of ADIT and
Unamortized ITCs From
Regulated Operations to
Nonregulated Operations

<u>Year</u>	<u>Description</u>	<u>Amount</u>
1985	Southern Bell - Ga. to ASI	? *
1987	Southern Bell - Ga. to BSS	approx. \$250,000
1989	Southern Bell to BSS	\$ 74,926
1991	Southern Bell - Ga. to BCI	\$213,333

*Amount not provided to auditors.

The 1985 transfer was from Southern Bell - Georgia to Advanced Systems, Inc. ("ASI"). Advanced Systems, Inc. was a subsidiary created to handle the Company's CPE business. Prior to the creation of a separate entity in 1985, the CPE assets attributable to Southern Bell - Georgia's ASI line of business were segregated from the company's regulated operations in Southern Bell's books of account on a below-the-line basis. In 1989, the CPE line of business was reintegrated into Southern Bell - Georgia as a nonregulated line of business and that such reintegration was the primary cause of the cross-subsidy discussed in Finding No. 12.

The 1987 and 1989 transfers were to BellSouth Services. As described in Finding No. 12, the Company began to add back BellSouth Services net income and equity to Georgia's earnings and rate base respectively. The Company contends that because the unamortized ITCs transferred to BSS continued to be amortized on BSS's books, Georgia's regulated customers received all the asset related tax benefits to which they are appropriately entitled.

In general, the auditors would agree with respect to the add-back of the 1989 amount. As explained in Finding No. 12, the BSS add-back appears to have resulted in a subsidy to the Company's nonregulated CPE line of business. While the add-back should have protected regulated customers, the CPE cross-subsidy convolutes the issue. The first year of the add-back was 1989. The regulated customers were not protected in 1987 or 1988 regarding the 1987 transfer.

Finally, the Company contends that the assets which were

transferred in 1991 to BCI had been assigned or apportioned to nonregulated on Southern Bell's books. The auditors examined the actual journal voucher associated with this entry. The ADITs in question were included in the following function codes ("FCs") while on Southern Bell's books: 5D85 and 5D8B. Both of these FCs are common and are allocated between regulated and nonregulated lines-of-business on the regulated company's books via the cost allocation manual.

Effect

The transfers above may or may not have resulted in subsidies to the Company's shareholders. The auditors believe the practice of transferring ADITs and unamortized ITCs generated and charged to regulated operations to nonregulated operations will result in subsidies to the Company's shareholders.

Cause

The Company cites to Part 32.27 of the USOA and certain IRS private letter rulings as the cause of these transfers. The auditors have found no specific Part 32 requirement to transfer ADITs and unamortized ITCs along with the related assets. Furthermore, the Company in fact retained the ADITs on the Southern Bell - Ga. books associated with the transfer of an airplane to BSS. The auditors are, however, cognizant of certain IRS private letter rulings which indicate that retention of unamortized ITCs attributable to assets no longer in rate base would violate

normalization requirements.

Recommendation

ADITs and unamortized ITCs which represent taxes charged to regulated operations should not be transferred to nonregulated operations. Such transfers result in a subsidy to the Company's shareholders. The Commission should require the Company to prove, on a case-by-case basis, that it will be in violation of the Internal Revenue Code before any ADITs or unamortized ITCs generated under regulation are transferred to nonregulated operations.

6. The Commission should be cognizant that the Company derives benefits through deferred tax activity in rate case years and non-rate case years.

Summary

The calculations and rules surrounding deferred tax calculations enable the Company to derive benefits in rate case years and non-rate case years. This finding demonstrates that the Company derived a cash benefit from deferred taxes in the Rule Nisi case, and reduced earnings and increased rate base through deferred taxes in non-rate case years. The auditors recommend that the Commission be cognizant of Company's ability to derive these benefits at the expense of its regulated customers in the tax area.

Criteria

Accumulated deferred income taxes ("ADIT") are deducted^A from the Company's regulated rate base because they represent cost-free capital derived from regulated customers through the regulatory process.

Condition

In general, deferred taxes have the following impacts:

- a). A debit (increase) to deferred tax expense and a credit to accumulated deferred income taxes results in higher expense with a corresponding reduction to the rate base.
- b). A credit (decrease) to deferred tax expense and a debit to accumulated deferred income taxes results in lower expense with a corresponding increase to rate base.

The Company derives a cash benefit when deferred tax debits

are included in allowable expenses in a rate case because the expense is noncash. These expenses are charged to customers in the form of higher rates and yet there is no corresponding cash outlay on the part of the Company. Furthermore, in a rate case the benefit to the Company of the increased cash flow normally exceeds the value of the corresponding rate base deduction. In non-rate case years it is in the Company's best interest to build rate base.

While reviewing the Company's tax return calculations, the auditors noted an anomalous situation concerning Southern Bell - Georgia's deferred tax expenses. The table below shows the Company's deferred tax expenses for each audit year. The only rate case during the audit period was the Rule NISI case which was based on a 1989 test year. The only year the Company recorded a deferred tax debit was 1989, i.e. the Rule NISI test year. The Company's deferred tax expense was negative for all other years. Thus,² the Company derived the cash flow benefit in the Rule NISI case and then built rate base in all other non-rate case years.

Summary of Deferred Tax Expense
1988 to 1991
(\$000,000)

<u>Year</u>	<u>Southern Bell Total Company</u>	<u>Georgia</u>
1988	\$ (5)	\$ (17)
1989	53	34
1990	(85)	(17)
1991	(135)	(13)

The deferred taxes were negative in the non-rate case years because the Company recorded expenses in those years which were not deductible for tax purposes: vacation pay accruals, for example.

Vacation pay accruals are also non-cash expenses. Therefore, in the non-rate case years, the Company recorded non-cash expenses which reduced net income on a net basis after the deferred tax credit, and at the same time increased its rate base through a deferred tax entry.

Effect

The Company derived a net cash benefit in the Rule NISI case, and then decreased net earnings while increasing rate base in the non-rate case years.

Recommendation

The auditors concur that this Finding does not identify any violation of GAAP, Part 32 or IRC provisions. Nevertheless, the auditors recommend that the Commission be cognizant of the Company's ability to derive benefits at the expense of its regulated customers through deferred tax activity in rate case years and non-rate case years.

7. Georgia PSC auditors should be provided access to all income tax returns and related workpapers.

Summary

The auditors have identified various tax-related findings, several of which identify cross-subsidies. However, the auditors were unable to reconcile Southern Bell - Georgia's 1991 tax calculation to BellSouth Telecommunications' tax return because the Company denied them access to records relating to any nonregulated operations other than those specifically provided by Southern Bell - Georgia. The customers of the Company's regulated services are not protected from cross-subsidy as long as access to such tax information is denied. The Commission should direct the Company to provide Georgia PSC auditors with unrestricted access to all tax returns and related workpapers.

Criteria

Telecommunications companies in Georgia may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tarified.²⁵ One of the objectives of this audit was to learn whether, as a result of the relationship between the Company's regulated telephone operations and its nonregulated activities and the nonregulated operations of its affiliates, Southern Bell's regulated customers are protected against cross-subsidy. The

²⁵O.C.G.A. Section 46-2-23(g).

Commission has defined cross-subsidy as any action undertaken by SBT which results in an understatement of intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.²⁶

Condition

The auditors identified a tax deduction being taken on the BSC Federal tax return which was associated with costs being incurred by the regulated operations. The tax benefit of this deduction was not being flowed down to the regulated operations. This situation, as discussed in Finding No. 1, resulted in a cross-subsidy from the regulated operating company to the nonregulated parent.

Given this cross-subsidy, the auditors considered it appropriate to review the parent company return and reconcile it to the Southern Bell - Georgia tax calculation. The auditors were denied access to any consolidating workpapers underlying the parent company's return and any subsidiary's tax return other than Southern Bell's and BellSouth Services'.

In response to audit request MJM-33 the Company offered certain consolidated tax information with the proviso that all BellSouth Enterprises information would be redacted from the workpapers. In essence, no workpapers underlying BellSouth Corporation's consolidated tax returns were shown to the auditors.

The auditors informed the Company that they intended to report their inability to reconcile these tax returns due to the denial of

²⁶Docket No. 3987-U.

access to the requested records. On November 19, 1993, the auditors were offered a list of the various affiliate tax returns. The Company was asked if the auditors could select affiliates from the list on a test basis and review those tax returns. The Company would not allow this approach.

Next, the auditors asked if they could select affiliates from the Cost Allocation Manual and review those returns. Again, the answer was no. The auditors determined that an unauditable list was worthless.

Audit request MJM-89 requested typical spreadsheet summaries of tax payments, taxable income and allocation of consolidated returns, tax credits and separate tax calculations, and summaries of tax and allocation entries resulting in final tax liabilities. The Company would not provide the information for any companies other than Southern Bell, South Central Bell, BellSouth Services and BellSouth Consolidated.

In a January 13, 1994 letter relating to audit request MJM-90 the Company offered to "provide the total bottom-line amount remitted by BellSouth Corporation on its consolidated tax return as well as a list of all entities that were party to the return". However, in a February 10, 1994 meeting, the auditors were informed that the subject list would not be provided.

Finally, the auditors were also denied access to nonregulated tax information relating to any other Southern Bell state. The table below summarizes the attempted reconciliation.

Attempted Reconciliation
of Tax Returns 1991
(\$000,000)

<u>Description</u>	<u>Amount</u>	<u>Able to Test</u>
1. SB - Ga. Fed. Tax Return Liability	\$111.5	Yes
2. Other Southern Bell States	<u>315.1</u>	No
3. Total Southern Bell	426.6	Reviewed return
4. Other Affiliates	<u>xxxx</u>	No
5. BellSouth Corporation	\$xxxx	Reviewed return

Effect

Anything other than an unqualified "yes" under the "Able to Test" column above results in an inability to perform the attempted reconciliation. Thus, the auditors were unable to perform the attempted reconciliation as a result of being denied access to certain documents. With the inclusion of this specific finding, the auditors have identified seven tax-related findings. Several of these involve cross-subsidies. Therefore, it is the auditors opinion that, unless the Georgia PSC auditors are provided access to all income tax returns and related workpapers associated with the consolidated return of which Southern Bell - Georgia is a member, Georgia's regulated customers are not protected against cross-subsidy.

Cause

Company denial of access to tax returns and workpapers relating to nonregulated operations.

Recommendation

The Company should be instructed to provide Georgia PSC auditors with unrestricted access to all tax returns and related workpapers.

8. The Company should be reprimanded for adding MemoryCall[®] losses to the Surveillance Report without notifying the Commission and the Company's failure to file tariffs and supporting cost of service studies.

SUMMARY

Inclusion in the Surveillance Report of MemoryCall[®] results beginning in June 1991 was not reported to the Commission. Full reporting of such results and filing of a tariff and cost of service study, including all workpapers in support thereof demonstrating that the price of MemoryCall[®] is just and reasonable, would have permitted a current appraisal of Southern Bell's progress in the transition to a competitive environment and be consistent with goals established by the Commission. The record relating to MemoryCall[®] is somewhat convoluted. It appears Southern Bell determined, on an informal basis, how it intended to interpret and implement the various provisions of the Order in Docket No. 4000-U.

At a minimum, the auditors believe that SBT should have notified the Commission and filed tariffs when it began to add MemoryCall[®] operating losses to regulated operations. This would have permitted a prompt and fair evaluation of the trial offering of MemoryCall[®].

Absent such a process, Southern Bell had the opportunity to interpret and implement the broad principles of the Order in such a manner as to disadvantage its competitors or otherwise act in a manner contrary to the public interest. The Company should be

reprimanded for its failure to notify the Commission, and its failure to file a tariff and supporting cost of service study.

Criteria

The following quotations are excerpted from the May 21, 1991 Order of the Commission in Docket No. 4000-U.

Nothing in this record disproves the possibility that MemoryCall[®] is cross-subsidized and/or predatorily priced. Rather, the record suggests the opposite possibility, namely that MemoryCall[®] is priced below cost.²⁷

Whatever the reasons, the actual cost analysis filed by SBT at the close of the Docket is insufficient to allow the record in this case to reflect a detailed, reasoned analysis of the true cost to SBT of providing MemoryCall[®].²⁸

ACTION TAKEN TO PREVENT AND/OR DETER MONOPOLY ABUSE

As explained in the Order, the Commission desires to promote the development of an efficient, competitive ES market, including specifically the VMS market. SBT's presence therein will assist that development, so long as SBT is practically prevented from using its monopoly position to unfairly promote and provide its enhanced services over its competitor's similar services.²⁹

Ordered further, that SBT shall file a complete cost of service study, including all workpapers in support thereof, demonstrating that the price of MemoryCall[®] is just and reasonable.

Condition

In Docket No. 3896-U, the Company was instructed to file tariffs and cost support relating to its MemoryCall[®] service.

²⁷Order of the Commission, Docket No. 4000-U, May 21, 1991, p. 41.

²⁸Id., p. 42.

²⁹Id., p. 47.

Certain cost data was filed on the last day of the hearings in Docket No. 4000-U. The Company informed the auditors that it has not filed tariffs because the 3896-U Orders were stayed and the order in Docket No. 4000-U did not specify tariffs.

According to line-of-business income statements, MemoryCall[®] has lost money each year since its inception. Appendix D to this report is a copy of the Company-developed 1991 line-of-business income statement for MemoryCall[®] with all numbers deleted. The Company contends that it is inappropriate to rely on this statement to determine the profitability of MemoryCall[®].

In June 1991 the Company began to add MemoryCall[®] losses to the regulated results of operations included in the Georgia Surveillance Report. The Surveillance Report made no mention of the add-back of the losses, and it is impossible to determine by examining the Surveillance Report that such an add-back was occurring. The Company did not identify specific MemoryCall[®] information because it was proprietary.

The only indication, prior to this audit, that MemoryCall[®] was included in the Surveillance Report was through cross-examination of a Company witness in Docket No. 3987-U on February 19, 1992, i.e. nine months after the Company began to add back losses to the Surveillance Report. The colloquies below represent the Company's advisement to the Commission.

By Commissioner Rowan: The Commission ---- this might not have been adjudicated all the way, but there's an assumption I believe on the Commissioners part that MemoryCall[®] was a regulated entity.

The Witness: A. Yes.³⁰

* * * *

By Mr. Adelman: Q. So at that point, was it the Company's position that MemoryCall[®] was regulated?

The Witness: A. I don't think it was the Company's position. It to me is a legal argument of whether it was regulated or non-regulated, and we appealed to the FCC to try to resolve that issue. But from the standpoint of the earnings report, since the Georgia Commission had ruled and that was the rule of the day, then the non-regulated -- previously non-regulated investment expenses for MemoryCall[®] were included in the intrastate results starting in June of 1991.

Mr. Adelman: Q. So it was in -- they were included 100 percent intrastate?

A. Yes, they were. That was the interpretation of the Commission's June Order as relayed to me. .

Mr. Adelman: No further questions, Mr. Chairman.³¹

The auditors do not agree that these colloquies represent official notification. Were it not for the questions, the Commission would not have been notified. Nevertheless, the Commission was notified.

³⁰Docket No. 3987-U, February 19, 1992, at 1062.

³¹Id., p. 1093 to 1094.

Effect

MemoryCall[®] losses have been absorbed by other regulated operations since June, 1991. In 1991 the add-back reduced the Georgia ROE from 12.03 percent to 11.85 percent. The Company's add-back of MemoryCall[®] losses to regulated operations without specific direct disclosure to this Commission hindered the Commission's evaluation of the trial offering of MemoryCall[®].

Cause

Company's interpretation of the Commission's Order in Docket No. 4000-U.

Recommendation

The auditors recommend that the Commission reprimand the Company by whatever means are available for adding MemoryCall[®] losses to regulated profits on the Surveillance Report without any notification to the Commission and without the filing of any tariffs and cost studies.

9. Southern Bell's construction program should be regularly audited.

Summary

The auditors' review of MemoryCall[®] construction program estimates revealed several errors. Incorrect coding on the two MemoryCall[®] estimates processed by SB in 1990 caused the capital costs involved to be initially assigned to regulated instead of nonregulated. Additional incorrect coding on one of these estimates caused 30 percent of the Right-To-Use ("RTU") software costs involved to be charged to capital, instead of expense. The December 1991 ARMIS Joint Cost Report failed to reflect as nonregulated plant-in-service over \$250,000 of MemoryCall[®] investment placed in 1990 and 1991. Although internal controls eventually detected and corrected the coding errors and the ARMIS issue was a timing difference, the RTU problem was not corrected until uncovered by this audit. The auditors recommend that internal and external audits of SB's construction program be scheduled on a regular basis to help ensure proper cost assignment.

Criteria

The initial assignment of investment is critical to the maintenance of an accurate separation of regulated and nonregulated costs. Absent special scrutiny, input errors may escape detection because of the magnitude of investment data processed each month and the complexity of related accounting systems.

Condition/Effect

The controversial nature of SB's MemoryCall[®] service led the auditors to carefully review the four MemoryCall[®] estimates processed in 1990 and 1991.³² It was found that the input code on estimates M1290 and M1418 was 615A0 instead of 615X1. This coding error led to the initial assignment of related capital costs to regulated, instead of nonregulated. Fortunately, this discrepancy was detected as part of SB's monthly review of Cost Separations System ("CSS") activity, and corrected in December 1990.

The audit further revealed that 30 percent of the RTU software costs on estimate M1418 was charged to capital (Account 2212,377C), instead of expense (Account 6212,377M). An adjustment was made in May, 1993, to correct this error.

The auditors also attempted to track the MemoryCall[®] investment placed in service in 1990 and 1991 to the December 31, 1991 ARMIS Joint Cost Report (FCC Report 43-03). The ARMIS Report was found to include \$3,881,807 of directly charged MemoryCall[®] Digital Electronic Switching (Account 2212) investment.³³ The four estimates completed by the end of 1991 contained \$4,169,151 of Account 2212 investment. As of January 1, 1993 it was found that \$4,139,474 of MemoryCall[®] related Account 2212 investment placed in 1990 and 1991 remained in service.³⁴ The difference between the

³²Estimates M1290, M1418, M1765 and M1842.

³³The ARMIS Report reconciles to the CCS/PPS Part X Summary for the month of December, 1991. Direct charges to Memory Call are found to be \$3,881,806.62 on page 30 of the CCS/PPS Part X Summary.

³⁴ICS/DCPR run dated January 2, 1993, pages 10756 to 10761.